FILED
MAR 1 1929
CHARLES ELMORE CR

IN THE

Supreme Court of the United States

OCTOBER TERM, 1928.

No. 482.

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE,
C. F. ROUTZAHN, COLLECTOR OF INTERNAL REVENUE,
Petitioners,

vs.

J. HARRY WIENER, *Respondent.*

BRIEF AS AMICI CURIAE.

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Washington, D. C.,
February 20, 1929.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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BRIEF AS AMICI CURIAE

This brief is filed by us as amici curiae, on behalf of The Brevoort Hotel Company, a corporation, of Chicago, Illinois, which corporation is plaintiff in a suit against Mabel G. Reinecke, Collector of Internal Revenue, now pending on appeal in the Circuit Court of Appeals for the Seventh Circuit (No. 4112, October Term, 1928) and involving in large part the question involved in the present case. The Brevoort Hotel Company case was originally before the United

States Board of Tax Appeals and is fully discussed in its reports. See 1 B. T. A. 132.

The Facts.

The basic facts are: The taxpayer during the year 1918 and for some years prior and subsequent thereto, was lessee of certain lots and a building built thereon by its lessor. The useful life of the building was 40 years from the date of the lease and the term of the lease was 99 years. The lease required the lessee to keep on the premises, in good repair and condition, a building, described generally in the lease, the building standing upon the premises at the end of the lease to become the property of the lessor. The rental in the Brevoort Hotel Company case was $60,000 a year for the 99 years. The lessee used the building in the operation of its business.

There is in the Brevoort Hotel Company case an additional fact which is materially different from the present case, and which,we contend, would entitle that company to the allowance even if it be denied your present respondent. That fact is that the Brevoort lease was executed long prior to 1913, and the lessee was in complete possession on March 1, 1913. We shall not discuss that feature in this brief, since it is not in this case.

Question To Be Discussed.

The question to which this brief is addressed is: Was this lessee in the computation of its taxable net income for 1918, for income and profits tax purposes, entitled to deduct from its gross income a reasonable

allowance for the exhaustion, wear, tear and obsolescence of the building referred to?

Statute Involved.

The Revenue Act of 1918 (c. 18, 40 Stat. 1057) provides:

> "Sec. 234 (a) That in computing the net income of a corporation subject to the tax imposed by Section 230 there shall be allowed as deductions:
>
> * * * * * * * * *
>
> "(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;"

ARGUMENT

The Statute Permits the Allowance to the User of the Property.

Our first argument appears plainly upon the face of the statute. The sole qualification expressed in the statute is that the property covered by the allowance be used in the business. The statute says nothing whatsoever about the ownership of the property. In the present case, the property was used in the business of the lessee, although not actually owned by him. The Government reads into the statute the additional implied requirement that the property must belong to the taxpayer. It would insert the words "belonging to the taxpayer" after the word "property" in the statute. We insist that the statute as written is sufficient and that there is neither reason nor excuse for extending its terms.

If the right to the deduction be conditioned upon the ownership of the property as well as its use in the business, it is clear that no allowance for the exhaustion of leased property would ever be permitted, since the owner is never the user of leased property. This is a result so unjust, unnatural and strained that it should be accepted only upon the plainest demands of the statute. Moreover, it is directly in conflict with the holding of this Court in *Lynch* vs. *Alworth-Stephens Co.*, 267 U. S. 364. If the qualification desired by the Government lie in the alternative to the expressed requirement that the property be "used in the business," the proposal does not assist the solution of the present problem, because we must still decide whether the owner or the user is entitled to the deduction in this particular case. If the Government urges that the owner share with the user to the extent of his interest, then in this case the total allowance would go to the user, since the owner has released the property for its full life, with a provision for the return of its equivalent, and thus has no interest in its exhaustion.

We wish to emphasize at the outset that the single expressed requirement of the statute is the *use* of the property in the business of the taxpayer. All other requirements must be written into the statute.

Practical Considerations Require Allowance to This Lessee.

The taxpayer lessee in the situation outlined above is confronted with a practical problem in dollars and cents, however much the legalists may theorize over his rights and obligations. He has a lease on a piece of land for ninety-nine years. On that land he has a

new building, which his lessor has built but which will last only forty years, less than half the term of the lease. The lessor during the life of the lease will build no more buildings on this land. This lessee must pay his lessor $60,000 a year for the entire ninety-nine years of the lease. Presumably the land will not sub-rent for any such figure; otherwise the lessor would not have included the building in that rental figure. Furthermore, the lease requires the lessee to keep the building in good condition and repair and to return to his lessor whatever building is on the premises at the end of the ninety-nine years. Here then is an economic compulsion upon the lessee to replace the worn-out building at the end of the forty years. The lessee's problems are: How shall he finance the construction of the new building? How shall he figure his real net profits for the first forty years of his lease?

Our contentions are that the Revenue Act permits the allowance for exhaustion, etc., contained in the section above quoted, to that taxpayer whose income is affected by the exhaustion; that the lessee in this case is compelled to build a new building on this land at the end of forty years, which second building is to belong not to the lessee but to the lessor, and thus it is the lessee in this case who must meet the loss occasioned by the exhaustion of the first building; that the lessee must meet this expenditure out of his income and therefore he is entitled to the allowance.

Real profit is the excess of the return over and above every expense and loss incurred to derive the return. One makes no profit if his return merely equals the expenditure he makes, or is obligated to make, to derive the return. His expenditure may be a current outlay for services or material, or a single

disbursement for so-called capital assets consumed or worn out or destroyed in the process of deriving the return. In any event he has no profit until the return exceeds the sums disbursed to derive it. This is the simple and practical way in which the lessee taxpayer in this case must face his problem of profit and finance. For forty years he has an annual gross return from his business, conducted in the building on the leased land; he has his recurring annual rental and his current and continuing expenses; at the beginning of the forty years he had the use of a new building and at the end of the forty years he must outlay the cost of a new building. That new building belongs not to him but to his lessor. Clearly this lessee's real profit for the forty-year period is the gross return less the forty years' rent, the current expenses and the cost of the new building. Unless he makes an allowance for the exhaustion of the building he is simply deluding himself as to the amount of profit from his business. The figure of ostensible profit is absolutely fictitious. He cannot shut his eyes to the enormous expenditure which must necessarily conclude the period. Provision should be made out of gross income to meet that expenditure.

The Rental Arrangement Contemplates Allowance to Lessee.

The obligation upon the lessee to build a new building was, as a business matter, as binding upon him as his obligation to pay rent and was directly related to the rental arrangement. When a lessor computes his rental requirements, he must consider two factors: (1) a return on his money and (2) the maintenance of

his capital intact. Where, as in this case, the lessee is required by the very nature of the transaction to replace the building within the life of the lease, the lessor has by that arrangement insured the maintenance of his capital, and need make no further provision out of income for that purpose. Assume that the value of the building was $800,000 and the life 40 years; the allowance for exhaustion would be, roughly, $20,000 per year. A yearly return to the lessor of 6% upon an $800,000 building would be $48,000. This is true income and he should pay tax upon it as such. If the lessee is to replace the building without cost to the lessor, there is no reason why the lessor should put aside $20,000 of this $48,000 to maintain his capital. Assume that the gross income of the lessee from the operation of the build is $100,000. Of this amount he must pay $48,000 as rent. In addition, he should set aside $20,000 to apply upon the $800,000 which he must pay his lessor, in the form of a new building, at the end of the term of the lease.

The absurd result of the Government's position is that the lessor, who receives a rental of $48,000 a year and is under no necessity of establishing a reserve for replacement, is allowed a deduction (if anyone is to be allowed a deduction) of $20,000 and pays a tax upon only $28,000; whereas the lessee may deduct only the $48,000 paid as rent and must pay a tax upon the $52,000 of his gross income remaining, although his profit for the year is clearly only $32,000. At the end of the forty years the lessee makes a payment of $800,000 to his lessor as part of the consideration for the use of the property but he receives for income tax purposes no deduction whatsoever from that sum. The lessor, on the other hand, has during the forty years

been relieved of tax upon $800,000 of what was purely a 6% return for the use of his capital. These figures given by way of illustration are, of course, wholly fictitious but this is the result urged upon the Court by the Government.

Our contention is that, in the foregoing case, the lessor should be taxed upon his clear profit of $48,000 annually and the lessee upon his clear profit of $32,000. To do otherwise is to do violence to the meaning of the words "net income subject to tax," since it would levy a tax upon the net income of the lessee plus $20,000 no part of which is profit to him, and at the same time relieve from tax $20,000 of the true income of the lessor. We contend that where the lessee is to replace the building, he should receive the allowance for its exhaustion; where the lessor replaces the building he should receive the allowance.

We contend that the burden of the destruction of the building was fixed by the parties in their contract and that the allowance should follow the burden. That was what Congress contemplated when it selected the phrase "*used* in the trade or business" to describe the property covered by the allowance.

This Court Has Approved Allowance to Lessee.

This Court in *Lynch* vs. *Alworth-Stephens Co.*, supra, has considered the principles involved in this controversy. The allowance under discussion in that case was "depletion," but, as the Court said in *U. S.* vs. *Ludey*, 274 U. S. 295, 303, "In essence the deduction for depletion does not differ from the deduction for depreciation." Our whole contention in this case is succinctly stated in a sentence used by the Circuit

Court of Appeals in the *Lynch* vs. *Alworth-Stephens Co.* case (294 Fed. 194), and quoted with agreement by this Court in its opinion in the case (supra, p. 370). That statement was, "The plain, clear and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to every one whose property right and interest therein has been depleted by the extraction."

The lessee in the present case has a very real interest in the building and his interest therein is property which was acquired under the contract and which is being exhausted as the life of the building runs out. Under the circumstances of this lease, the value of the lessee's interest is the whole value of the building, since the lease runs longer than the building and its terms compel, even if they do not specifically require, the lessee to make whole the lessor in respect to such exhaustion.

The Government's Theory Stated.

It is in the realm of legalistic controversy rather than in the field of practical results that the Government takes its stand to dispute any allowance to this lessee on account of the admitted exhaustion of the building admittedly used in his business. The statutory allowance, says the Government, is to return to the taxpayer tax-free his capital investment. In *Ostheimer's Appeal*, 1 B. T. A. 18, quoted in *The Brevoort Hotel Company* case, supra, page 135, the Board of Tax Appeals says that this allowance "is based upon the principle of allowing a taxpayer a return of the capital invested in his business before subjecting his earnings therefrom to tax." The Government

reasons that for thirty-nine years, eleven months and twenty-nine days this taxpayer lessee has made no capital investment in this building; therefore, for that period he is to be permitted no allowance; since we have not yet reached the last day of the fortieth year, we are not concerned with what may happen to him on that day, or on the last day of the ninety-ninth year of his lease.

Allowance is to Replace Property Exhausted, Not to Return Capital Investment.

We insist that the Government's theory will not bear critical analysis. The unmodified return-of-capital-investment explanation of this statutory allowance, which is the sole basis for the Government's contention in this case, is incomplete, inaccurate and untenable. In the first place, the statute makes no reference to either "capital" or "investment." The petitioners' entire conception is an insertion of an extraneous theory into the otherwise clear language of the statute. In the next place, the Government's theory seems to treat the allowance as a capital adjustment, whereas the statute is not so constructed. The statute does not *exclude* these amounts from income, as if they were capital. It deducts them from gross income to get *net* income. There is no justification for an unrestricted return of capital *out of* income. There is reason and justification, and even necessity, for a return out of income of property which has been consumed or lost or worn out in the process of deriving the income. Such losses are operating expenses. A building used up in forty years is no different from a ton of coal used up in a week or a kilowatt of electricity consumed

in a minute. In the manufacture of automobiles, factory buildings are worn out; the value thus consumed is part of the cost of the manufacture of the automobiles, just as is the value of the steel, the coal, the electricity and managerial skill which is consumed. In the hotel business, which was the business of the Brevoort Hotel Company, the value of the building is translated into service sold the guests, just as are the values of the stationery, soap, and servants' hire. If capital be consumed or lost or worn out in the winning of the profit, there is excuse and justification for an allowance for its return out of income; if the capital be not so consumed or lost or worn out there is neither excuse nor justification for the allowance. The sum total of the outgo must be reckoned before a figure of profit (*net income*) emerges from the gross returns. On that basis the allowance can be justified but on no other.

Our suggestions in this respect are supported by the views expressed by this Court in *U. S.* vs. *Ludey*, 274 U. S. 295, 300, and in *Von Baumbach* vs. *Sargent Land Co.*, 242 U. S. 503. In the Ludey case the Court said:

> "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents *the reduction*, during a year, of the capital assets *through wear and tear of the plant used*. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that *by using up* the plant, a gradual

sale is made of it. The depreciation charged is the measure of the cost of the part which is sold."

In the Von Baumbach case (p. 524) the Court referred to depreciation as "*the annual losses* for wear and tear and obsolescence of structures, machinery, any personalty in use in the business."

If the allowance be solely for the purpose of returning capital investments, numerous complications immediately appear. 1. Under that theory land, stock and bonds would seem to be depreciable. 2. Under that theory no justification appears for spreading the allowance evenly over a term of years, as is the custom. It would seem proper to return *all* the investment before *any* income appears. 3. The proper deduction would be a constitutional question, since Congress must of necessity exclude all capital from this tax. 4. No depreciation could be taken in the computation of a net loss for a year, since no capital can be returned out of a deficit. 5. No depreciation would be allowable upon property acquired by gift or devise since such property represents no investment. 6. The 1909 corporation Tax Act (c. 6, Sec. 38, 36 Stat. 11) and the 1913 Income Tax Act (c. 16, 38 Stat. 114) would both be erroneous in their treatment of the deduction, since they include it in "losses actually sustained during the year." (See Section Third (fifth) of the 1909 Act and Section G (6) (second) of the 1913 Act).

None of these difficulties appear if the purpose of the allowance be considered to be the return of the value of assets consumed or destroyed in the derivation of income allowed to those interested in the prop-

erty to the extent of their several economic losses through such consumption or destruction.

Perhaps the most complete discussion of depreciation is to be found in the report of the Interstate Commerce Commission on the subject (118 I. C. C. 295) which study was made pursuant to an act of Congress. The position we suggest as to the real nature of the depreciation allowance is supported in that report.

Title to Property Does Not Control Allowance.

Following out its general theory of the nature of the allowance, the Government necessarily insists upon the presence in the taxpayer of the legal title to the property. The Board of Tax Appeals in the *Brevoort Hotel Company* case, supra, conceded the pertinence of our suggestions as made above, but insisted that the pivotal question was "*whose* assets are consumed?" and answered the question by holding that they must be the taxpayer's assets. This is a subtle suggestion, but fallacious. It underlies the whole opinion of the Board of Tax Appeals in the *Brevoort Hotel Company* case, supra. The major premise from which the Board and the Government reason is that the exhaustion, etc., of all property falls upon the owner. The fallacy is the fallacy inherent in syllogistic reasoning; the major premise is so broad as to assume the quod erat demonstrandum. The exhaustion of all property does not fall upon the owner; sometimes it falls upon some one else. In the Brevoort Hotel Company case, supra, the Board of Tax Appeals says: "If in his business A consumes the coal of B, he has no deductible fuel cost; and if he exhausts B's building it adds nothing to *his* cost of operation." But plainly if A makes an agreement with B to replace or to pay

for at the end of a term, all of B's coal consumed by A during the period, A has a deductible fuel cost as he burns the coal (assuming that he is upon an accrual basis as all these taxpayers are). Similarly with respect to B's building, which is this present case.

Past Investment Not Necessary to Allowance.

The Government greatly overemphasizes the "investment" feature of its theory. That, in our view, is a non-essential. An obligation to pay is as effective a reduction of profit as is an actual disbursement, so long as the obligation arises in the derivation of the income. As this building was consumed by use the lessee concurrently incurred an obligation equal to the consumed portion of the building. His balance between receipts and obligations was precisely the same as it would have been if he had owned the building and instead of incurred obligations had on his books a reserve for capital consumed.

The Government insists upon a *past* capital investment as a predicate to the allowance. Similar sophistry would prohibit to a stock trader selling "short," the tax-free return of his costs. We contend that the time of the investment or expenditure is totally immaterial, so long as it is a necessary outlay to the winning of the profit. The computation of profit is not necessarily chronological; cause and result are the criteria of its factors.

Perhaps the "short" stock sale is the most vivid simile to the present situation. If, as this Court said in *U. S.* vs. *Ludey*, supra, the theory underlying depreciation is that "a gradual sale" is being made of the property, then in the present case a gradual "short"

sale is being made. As we have suggested above, there is no difference, for income tax purposes, between a "short" sale and an ordinary one. In either case the profit is the difference between receipts and costs. Whether the taxpayer buys first or sells first is utterly immaterial. So in regard to depreciation ("a gradual sale") it is utterly immaterial whether the taxpayer first acquires assets and then consumes them, or whether he first consumes and then pays for them.

Difficulties Encountered by Government.

In the past the effort of the Commissioner of Internal Revenue to apply consistently his theory, including the insistence on both ownership and possession, has caused him to take positions in various situations which were so incongruous as obviously to necessitate judicial correction. These include, (a) the refusal of depreciation on leasehold interests acquired prior to March 1, 1913 (I-2 Internal Revenue Cumulative Bulletin 90), a position which practically amounted to the denial that a leasehold estate was property which was corrected by the decision of *Atterbury* v. *Commissioner*, 1 B. T. A. 169; (b) a denial of depreciation to life tenants (I-1 Internal Revenue Cumulative Bulletin 172) which was corrected by *Grant* v. *Rose*, 24 Fed. 2nd 115; (c) a refusal of a deduction for depletion to the lessee of a mineral lease (Regulations 33, p. 527, 528) corrected both by statute as applied to later years and by *Lynch* v. *Alworth-Stephens Co.*, supra; (d) in one case the owner had absolutely eliminated any effect of depreciation on his property value by leasing for a ten year period under a lease containing a bind-

ing contract on the lessee's part to purchase within that period. The Commissioner claimed that, since the property had depreciated during the ten years, the owner by then obtaining the price determined at the beginning of the ten year period had increased his profit by an amount equal to the depreciation during those ten years (See *Schoellkopf* v. *Commissioner*, 4 B. T. A. 1032). Obviously this position was an argumentum ad absurdum of the capital investment theory.

CONCLUSION

We contend that the gist of the statutory allowance is the destruction or consumption of the assets and not merely the return of a capital investment. We therefore contend that the taxpayer to whom the allowance is made is the one who must make good the assets destroyed and is not merely the person who owned them.

In short, the controversy is this: The Government insists that the allowance must be predicated upon a prior capital investment, whereas we contend that the allowance is purposed to restore him upon whom the loss from the exhaustion of the property falls by reason of its use in the business. We submit that the practical features of the situation, sound economics, sound finance and the conclusions of this Court in *U. S.* vs. *Ludey*, supra, and in *Lynch* vs. *Alworth-Stephens Co.*, supra, support our views. Especially do we urge that the plain language of the statute supports our view and no reason appears for grafting additional qualifications upon those laid down by Con-

gress. The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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